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December 30, 2003

Thomas M. Dorman, Executive Director
Public Service Commission
211 Sower Boulevard
Frankfort, KY 40601

RE: Responses to Commission staff and Company data requests in In the Matter of: An Investigation Pursuant to KRS 278.260 of the Earnings Sharing Mechanism Tariff of Kentucky Utilities Company, PSC Case No. 2003-00334 and An Investigation Pursuant to KRS 278.260 of the Earnings Sharing Mechanism of Louisville Gas and Electric Company, PSC Case No. 2003-00335

Dear Mr. Dorman,

Enclosed herewith are the original and seven copies responses of the Attorney General to data request posed by Commission staff by Order dated December 15, 2003 and to data requests posed by LG&E and KU. By this letter I certify that all parties have been served with a complete and true copy of the responses with the exception of diskettes. The responses to the data request of LG&E and KU require two diskettes that have been included only in the following: the original supplied to the Commission, the copy provided to John Wolfram and to Robert Rosenberg on behalf of LG&E and KU, Mike Kurtz, Mike Laros and David Barberie.

Sincerely,

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cc: Mike Beer
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David Barberie

Responses of the Attorney General's Witness
Carl G. K. Weaver to
Commonwealth of Kentucky PSC Case No. 2003-00334
and Case No. 2003-00335
Commission Staff 1st Data Request

1. Refer to pages 8 and 9 of the Direct Testimony of Carl G. K. Weaver ("Weaver Testimony"). Dr. Weaver recommends on page 8 that the Commission establish a target percent of equity for the Earnings Sharing Mechanism ("ESM") of 52.5 percent, but on page 9 states that the target percentage of equity should be set at 50 percent.

a. Describe in detail why Dr. Weaver believes the Commission should modify the ESM to utilize a target equity component. This discussion should indicate whether Dr. Weaver's recommendation is related to the Barrington-Wellesley Group, Inc. audit report.

b. Is Dr. Weaver aware of any other regulated utilities currently or previously under an ESM that utilized a target equity component and a capital structure activation limit?

c. If yes to part (b), identify the utility and provide copies of the regulatory commission decision authorizing the use of a target equity component and a capital structure activation limit.

d. Clarify Dr. Weaver's recommendation of the percentage that the Commission should set for determining the equity percentage to be used in the ESM calculation.

e. Provide a numerical example of the adjustment that Dr. Weaver recommends for each of the leverage components when resetting the equity percentage.

f. Dr. Weaver recommends periodic reviews of the equity target in the capital structure. How often does Dr. Weaver recommend reviewing the target?

Answer:

The target capital structure is 50%. The "capital structure target activation limit" is 52.5%. The "capital structure activation limit" is needed because management does not have precise control of the capital percentages in its capital structure. This is discussed on page 13 in lines 3 through 13.

a. The Barrington-Wellesley Group, Inc. audit report indicated that, " the ESM provides no direct control over financing costs or capital structure although the Commission has other means to exert control over these items." The other means of control refers to the requirement that the Commission approve external financing arrangements. As I point-out on page 6 in lines 11 through 23, an increase in the equity ratio increases the overall rate of return requirement. Furthermore, increasing the amount of equity in the capital structure to reduce financial risk beyond an optimal amount does not increase the company's value. It does increase the revenue requirement requirement but has little effect on the company's value as measured by price earnings ratios because the cost of foregoing leverage exceeds the benefit from the reduction in risk. This is discussed on page 7 and at the top of page 8. The higher equity component in the capital structure requires that LG&E's and KU's customers pay more for electricity but the higher payment has little effect on the market value of the companies because of the foregone leverage benefits.

b. I am not aware of any other regulated utilities currently or previously under an ESM that utilize a target equity component and capital structure activation limit.

c. n/a

d. I recommend that the target equity component be set at 50%. However, because management does not have precise control over the percentages in the capital structure, a "capital structure activation limit" be set at 52.5%. This is discussed in the testimony on page 8, lines 3 through 14.

e. A numerical example of the adjustment to the capital structure for each of the leverage components is shown in Schedule 50. The capital structure and cost rates for the leverage components were taken from the BWG Report, page V-10, the structure filed on May 22, 2003. The equity percentage is to be reduced by 9.60 (59.60 – 50.00) and this is to be spread proportionally over the leverage components.
The structure and adjustments are as follows:

	Pct.	Lev. Pct.	Proportion Of Adjustment	Amt. Adj.	Org. Pct.	Adj. Pct.
Short-term Debt	5.68	5.68	(5.68/40.39)*9.60=	1.35 +	5.68	7.03
A/R Securitization	3.23	3.23	(3.23/40.39)*9.60=	0.77 +	3.23	4.00
Long-term Debt	28.40	28.40	(28.40/40.39)*9.60=	6.75 +	28.40	35.16
Preferred Stock	3.08	3.08	(3.08/40.39)*9.60=	0.73 +	3.08	3.81
Common Equity	59.60	00.00				50.00
Total	100.0	40.39				100.00

f. I believe that the annual filings and the reviews of the annual filings should continue as long as the ESM is being used. The equity target, like the equity return, should be reviewed in the annual filings whenever a party to the review proceeding makes a request to do so and files testimony in support of the request.

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2. Refer to page 13 of the Weaver Testimony. Dr. Weaver recommends setting an upper limit of 2.5 percent above the 50 percent target. Explain the derivation of the recommended 2.5 percent.

Answer:

As I explained in the testimony on page 13, lines 3-13, management does not have precise control over the capital percentages in its capital structure. The "Capital Structure Activation Limit" at 52.5%, which is 2.5% over the target capital structure of 50% was a judgment call.

As I discussed in my direct testimony on page 13, in lines 16 through 20, the 2.5% allows book equity for KU to be \$27.8 million above its 50% target. In other words, KU's equity could vary \$27.8 million above management's itended 50% equity capitalization before invoking the 50% equity cut-off. In 2002, according to data in the FERC Form 1, KU's equity increased by \$79.1 million. The \$27.8 million variation allowance is 35% of that amount. In 2002, KU did not pay common dividends to E.ON. Based on data in the ESM filings, KU's common equity capitalization increased by \$17.1 million in the 2001 filing over the 2000 filing and by \$61.6 million in the 2002 filing over the 2001 filing.

The 2.5% allows book equity for LG&E to be \$34.2 million above its 50.0% target. LG&E's equity, according to data in the FERC Form 1, decreased by \$4.9 million is 2002. The decrease is due in part because of the common dividend in the amount of \$69 million paid to E.ON. Based on data in the ESM filings, the common equity for LG&E was \$10.3 million lower in 2001 than in 2000. In 2002, it was \$28.2 million higher than in 2001.

For both companies, the 2.5% allowance appears adequate to allow for variation that is beyond management's control.

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3. Refer to page 24 of the Weaver Testimony. Dr. Weaver uses five comparison companies to develop his recommended return on equity for LG&E and KU. Explain why five companies is a large enough sample to develop a dependable result.

Answer:

To obtain data for the cost of equity analysis, I had to select companies that have common stock that is traded in the capital market. KU and LG&E are not, in my opinion, "average" electric utility companies. A larger number of companies will cause the cost of equity results to reflect the risk of an "average" company rather than the risk of companies that are more similar to LG&E and KU.

Had I used a large data sample, say 21 companies that I found to qualify as potentially candidate companies, I would be implicitly assuming that both KU and LG&E are average of these companies. This would be an incorrect assumption. LG&E has 50.3% common equity and KU has 59.6% common equity according to the 2002 ESM filing. The 21 companies have an average of 42.4% common equity. Both LG&E and KU have much less financial risk than the 21 companies. A financial strength rating is considered average. I am certain that both KU and LG&E would have an above average financial strength rating. Also, both LG&E and KU have different percentages of electric sales relative to each other and relative to other companies. This diversity affects risk and equity costs.

The underlying assumption in choosing companies that are as similar as possible to KU and LG&E is that the cost of equity of these companies is representative of the cost of equity for KU and LG&E. The five companies that I selected to represent LG&E were, in my opinion, as close as possible to being representative of the risk of LG&E and therefore, its equity costs. The same is true for KU. I performed a careful risk analyses to assess the risk differences and adjusted the results based on that risk analysis.

The five companies selected are above average companies, the risk analysis identifies the differences, and the analytical results are better representative of LG&E and KU. A larger number of companies would cause the results to be more reflective of an "average" utility. This would reduce the accuracy of the results as being reflective of LG&E and KU rather than increase the accuracy of the study.

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4. Refer to page 44 of the Weaver Testimony. Dr. Weaver states that he chose a time period for the historical growth rate that does not contain a period of economic contraction. Explain the effect of using a larger time period that does contain periods of economic contraction.

Answer:

The time period chosen for obtaining data for the historical growth rate is not biased downward by the phenomenon referred to as cyclical bias. If a longer period that contained two cyclical contractions and a single period of growth, the historical growth estimate would be too low to the extent that economic conditions affect earnings. The effect of business conditions is greater when a utility has a larger industrial and commercial load. If a data series has two periods of low EPS growth, its compound growth rate will be lower.

To avoid cyclical bias, the time period selected for obtaining data should contain a complete business cycle rather than more periods of growth than decline or conversely, more periods of decline than growth. In my testimony on page 44, lines 1-9, the period 1992 through 2000, cyclical bias is avoided.

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5. Refer to KU's responses to the Commission Staff's First Data Request dated October 30, 2003, Items 29(f) and (g). KU is seeking approval of the deferral of net ice storm costs for recovery in future rate proceedings before the Commission. Provide any comments or recommendations Dr. Weaver has concerning KU's request to defer the net ice storm costs.

Answer:

I recommend that KU not be allowed to defer the net ice storm costs. Obviously, a deferral will allow near full recovery of the costs while including the costs in the ESM will allow only a 40% recovery. This is one of the risks that are present in an ESM. This also why a capital market determined cost of equity may be used to establish an ROE target in the ESM.

If the ice storm costs are deferred for inclusion in a general rate case, this element of risk is removed and the target cost of equity in the ESM should be lowered. It is true that the costs of such risk items are recoverable in a general rate case with regulatory lag and uncertainty.

The ESM annual adjustment procedure eliminates a large amount of regulatory lag and the 60/40 earnings sharing mechanism retains incentives for risk reduction. Without the risk reduction incentives, an implicit contra-incentive would exist to reduce tree trimming and other maintenance expenses because the incurrence of cost from the realization of risks be recovered, with regulatory lag, in a general rate case. This would result in more risk being transferred from the company to the ratepayers and consequently, the target cost of equity should be lower.